This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 TEGUCIGALPA 002648

SIPDIS

SENSITIVE

STATE FOR WHA/CEN, WHA/EPSC, DRL/IL, EB/IFD/OMA, INR
STATE PASS AID FOR LAC/CEN
STATE PASS USTR FOR BRETT MAKENS
TREASURY FOR E. ILZETSKI
DOL FOR ILAB

E.O. 12958: N/A
TAGS: EFIN ECON PGOV EAID ETRD ELAB EAGR PINR HO
SUBJECT: IMF TEAM RETURNING TO HONDURAS TO NEGOTIATE A LETTER OF INTENT THIS MONTH

REF: TEGUCIGALPA 2034

¶1. (SBU) Summary. An October IMF mission visit to Honduras found enough progress and high-level commitment to agree to return in November for the negotiation of a Letter of Intent (LOI) for a Poverty Reduction and Growth Facility (PRGF) program. The government hopes to be able to push legislative measures through Congress that would address all prior actions identified in the LOI, by the end of November. The IMF staff showed flexibility in this visit, loosening up a bit on the fiscal targets of the budget deficit and the staged-in decline in the wage bill. The GOH and IMF staff both envision that the program will also require new tax measures, particularly elimination of additional exemptions. This extremely ambitious schedule is a recognition by all parties of the limited political window of opportunity for reaching an agreement. One of the danger signs is that the GOH will need substantially higher levels of foreign assistance from donors in the next three years in order to meet these fiscal targets and still meet its commitments to poverty reduction spending. As the director of the IMF mission told the donors before departing, however, "there are dangers on all sides." End Summary.

¶2. (SBU) At the GOH's request, an IMF mission led by Assistant Director of the Western Hemisphere Department Adrienne Cheasty and mission chief Mario Garza held productive consultations with the GOH in Honduras on October 13-23 on the current fiscal situation and prospects for a three-year PRGF program. Cheasty indicated to the G-15 donors group, before the mission's departure, that the GOH had shown enough commitment to addressing the structural fiscal problems, that they were willing to recommend a return mission in November to negotiate a letter of intent (LOI). Note: Post now understands that the mission is scheduled to return during the week of November 10 to begin negotiations in earnest. End Note. The GOH has indicated its strong determination to reach agreement with the mission on the LOI quickly, and to achieve rapid legislative approval of laws required as prior conditions in the LOI, by the closing of the legislative session at the end of November. That would free up the GOH to adopt the 2004 budget during its traditional "extraordinary" session in December. While this represents an extremely ambitious schedule, all sides are trying to make it work in recognition of the limited political window of opportunity for reaching an agreement. In 2004, the GOH expects its ability to push through tough legislative measures to diminish rapidly. In addition, the fiscal situation is deteriorating with non-inflationary sources of deficit financing rapidly drying up and the GOH needs an agreement to free up new sources of financing and debt relief.

¶3. (SBU) The IMF mission described the baseline fiscal situation as fairly bleak. The Central government's deficit is expected to reach 5.5 percent of GDP in 2003, or 2 percent higher than the GOH's target (although the GOH would argue that it is really just 1 percentage point higher than the target and that the IMF is not correct in charging the full cost of the agricultural loan debt forgiveness program to the year 2003, as the costs will be spread out over ten years). Other contributing factors to the higher deficit are: the high public wage bill (10.6 percent of GDP vs. the 10.0 percent target), because administrative measures were not successful in compensating for the rising teacher and medical employees' salaries; cost of transferring a troubled state-owned bank to private Banpais (covering its liabilities with bonds); and a large shortfall in the revenues projected to come from the tax measures that were adopted in May 2003. The GOH is financing this greater than expected deficit by drawing on foreign reserves and issuing bonds. Net reserves in the Central Bank declined by more than USD 100 million in the first nine months of the year.

¶4. (SBU) For 2004, if the government takes no new measures, the deficit will be approximately 4.4 percent of GDP. The IMF staff is even more concerned about prospects for 2005 and

2006, as the projections for increased social spending rise necessarily (to meet poverty reduction targets) and available non-inflationary deficit financing decline.

The Outlines of a Program

¶5. (SBU) The IMF (very tentatively and not yet negotiated with the GOH) plans deficit targets of 3.5 percent in 2004, 2.5 percent in 2005 and 2.0 percent in 2006. They acknowledged that this is somewhat faster than would usually be sought for a country with such great poverty reduction needs, but indicated that it is necessary because of the limited non-inflationary financing available. The Fund asks bilateral and multilateral donors to look for possibilities of additional donations that would help the government maintain social spending. Very tentatively, and even with expenditure and revenue measures, the Fund staff estimates the GOH will need USD 120 million in new funding in 2005 and USD 175 million in new funding in 2006.

¶6. (SBU) Note: Because the burgeoning wage bill has been one of the main reasons for the structural fiscal deficits, the IMF staff plan to require, as a prior action, the enactment of legislation that provides the executive branch with control over wage policy and that begins to reduce the wage bill as a percent of GDP. End Note.

¶7. (SBU) The IMF is no longer requiring this percentage to decline by one percentage point a year, perhaps as recognition of the political constraints in reopening the wage agreement with the teachers that would be the only practical way of achieving this reduction. Both the Finance Minister and IMF Resident Representative indicate that the two sides are now in agreement on the text of the wage legislation, which will grant the executive branch wage policy control and will also freeze the collateral benefits that are provided to teachers and doctors (in the special statutes governing these professions).

¶8. (SBU) To compensate for the shortfall in revenues coming from the May 2003 tax package, adopted in May 2003, the GOH is considering a sizable increase in the taxes on gasoline and diesel. Other potential measures, such as an increase in the sales tax or elimination of popular tax exemptions like the exemption on residential electricity, have been ruled out so far by President Maduro and his inner circle on political grounds. The GOH believes that this gas tax hike, along with the freezing of the teacher collateral benefits, will provide the needed revenue to make up the potential shortfall in 2004 between the baseline budget deficit (4.4 percent) and the expected target of 3.5 percent.

¶9. (SBU) The program will also require the elimination of exemptions provided to the wealthy and to many companies. The government is likely to do this in the context of adoption of legislation enacting the key measures from the Fiscal Pact recently signed in the context of the National Dialogue among the government, private sector and civil society. Congress President Pepe Lobo has announced his intentions to push for enactment of this legislation starting in January 2004.

¶10. (SBU) In the financial sector, the program will require the GOH to raise requirements for provisioning for bad loans, in accordance with Basel standards. The IMF resident rep indicated that this might also be made a prior condition in the Letter of Intent. In addition, the IMF will require the government to make changes to Central Bank operations to reduce losses incurred as part of the execution of monetary policy operations. This was an issue identified in the Financial Sector review performed by a joint IMF-World Bank team early this year. Finally, it appears the IMF staff is going to accept that no further changes to the agricultural credit law are politically/ legally possible at this point.

Comment

¶11. (SBU) This may be the now-or-never point for President Maduro to reach an agreement with the Fund in his time in office, and the GOH seems to know it. With the President's full engagement now, Post expects the GOH to do its best to use this window of opportunity. The wage policy legislation, if adopted, will be a major, overdue milestone toward structural reform. It will have to be closely followed, in early 2004 with the development of a professional civil service, legislation enacting the Fiscal Pact developed in the National Dialogue process (see septel) and elimination of a series of tax exemptions. End Comment.
Palmer